



COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON D.C. 20548

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September 2, 1982

B-208698

The Honorable John Glenn
United States Senate

Subject: Proposed Arms Sales Legislation Should
Be Subject to Arms Export Control Act

Dear Senator Glenn:

On June 15, 1982, you requested that we comment on proposed legislation (H.R. 6370) to amend section 107 of the Foreign Assistance Authorization Act of 1983 that would allow the U.S. Government to sell Government-furnished equipment to U.S. contractors for incorporation into an end item for export. Because of anticipated delays in passage of security assistance legislation, an independent bill (H.R. 6758), intended to accomplish the same objective, was also introduced and passed by the House of Representatives on July 19, 1982.

The most important consideration about each of these bills is that neither proposes to enact the provision as part of the Arms Export Control Act (AECA) but are free standing; therefore, various congressional restrictions and controls over the sale of defense articles and services would not apply. These bills also differ from each other in two ways that further affect controls. First, H.R. 6758 authorizes the Secretary of Defense to sell these items whereas H.R. 6370 authorizes the President to do so. Second, H.R. 6758 would permit defense services to be sold in addition to the defense articles and unclassified publications which the Government could sell to U.S. contractors under both bills.

Without these or similar legislation, the U.S. Government has no authority to make sales directly to contractors. To date, the AECA authorizes sales only to an eligible country or international organization. The U.S. Government, as a sole source supplier of some defense equipment, requires the country to enter into a government-to-government agreement with the United States to acquire the equipment. This agreement may either take the form of a foreign military sales (FMS) agreement or another agreement designating the U.S. contractor as the agent of the purchasing country. One reason cited for enacting the legislation is to avoid this increased government red tape.



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For political reasons, some countries will not enter into government-to-government agreements with the United States to purchase weapons. Even though the U.S. Government may support these sales, in the absence of this or similar legislation, U.S. contractors appear to be blocked from negotiating such sales. With this legislation commercial sales are expected to increase.

U.S. Government and contractor officials strongly support the objective of these bills. However, U.S. Government agencies want this legislation to be incorporated into the AECA and they want defense services to be restricted to those required for installation, testing, and certification of Government-furnished equipment. Unless H.R. 6370 or H.R. 6758 is amended along these lines, we do not support these bills.

RESTRICTIONS AND CONTROLS

Although exports of defense articles require export licenses and are subject to restrictions contained in the International Traffic on Arms Regulations (ITARs) (22 C.F.R. Part 121), U.S. officials responsible for export control had the following concerns over the proposed bills.

- Interagency coordination may not be required when approving the sale of Government-furnished equipment and services from U.S. Government arsenals.
- There is less review by the military services under export licensing reviews than under FMS programs.
- Defense services provided independent of an end item may not require an export license.

Delegation of authority affects interagency coordination

The AECA sets forth U.S. Government rights and controls over the sales of military equipment to friendly countries. Although the responsibilities for the continuous supervision and general direction of the sale of military hardware rest with the Department of State as delegated by the President, other agencies, such as the Department of Defense (DOD) and Arms Control and Disarmament Agency (ACDA), are directly managing and implementing the program and involved in providing technical information and opinions. For example, an ACDA official pointed to Section 36 of the AECA, which requires ACDA to evaluate FMS cases in consultation with the Secretaries of State and Defense.

Department of State and ACDA officials explained that the subtle difference of designating the Secretary of Defense rather than the President authority to negotiate the contracts may reduce the coordination process. They stated that if the President is the designated officer, their agencies will likely have an opportunity to review the Executive Order covering the delegation of

Presidential authority. Under the proposed H.R. 6758, there will probably be no Executive Order. Therefore, these agencies may lose an opportunity to voice an objection that they are being bypassed in decisions affecting their areas of interest.

Free-standing status
affects coordination

Because H.R. 6758 and H.R. 6370 are free-standing bills, coordination between State, DOD and ACDA is not required until a commercial arms export license is requested. Officials of these agencies told us that the military services or DOD may approve Government-furnished equipment sales from U.S. Government arsenals without advance coordination with other U.S. agencies. This may increase pressure to approve the export license by State when requested by the contractor. The officials noted that the proposed legislation does not require a contractor to obtain an export license before procuring such equipment from the arsenals.

If the proposed legislation is under AECA controls, Government officials felt assured the commercial and FMS coordination process as prescribed in Section 36 of AECA would apply to Government-furnished equipment sales to U.S. contractors. They were not opposed to contractors purchasing such equipment; however, they wanted to know the item, number, and possible recipients of the end items.

Defense services may not
require export licenses

A State Department official expressed concern that ITAR section 126.04 may allow contractors to solicit defense services from U.S. Government arsenals without obtaining export licenses. Therefore if services are provided by the U.S. Government under a commercial contract as authorized by these bills, State and ACDA may not have an opportunity to review the transfer of services. These concerns can be resolved by amending H.R. 6758 to tie services to the contractor's end item. According to Section 126.04 of the ITAR:

"(a) The export of articles on the U.S. Munitions List by any department or agency of the U.S. Government is not subject to the provisions of section 414 of the Mutual Security Act of 1954, as amended. A license to export such articles, therefore, is not required when (1) all aspects of a transaction (export, carriage, and delivery abroad) are effected by a U.S. Government agency, or (2) actual transfer of possession of U.S. Government-owned articles is effected in the United States by an agency of the U.S. Government to a foreign government or its carrier and no private person or forwarding agent is involved in the export transaction."

GOVERNMENT OBLIGATIONS AND
LIABILITIES NOT COVERED IN
PROPOSED LEGISLATION

Two of the issues raised most frequently during our review were Government rights to (1) establish priorities in the procurement, delivery, and allocation of military equipment, and (2) cancel any contract for compelling national security reasons.

With regard to setting priorities, section 42(d) of the AECA provides that for stock, cash, or military construction sales

"the establishment of priorities in the procurement, delivery, and allocation of military equipment shall, under the direction of the President, be determined by the Secretary of Defense."(Underscoring supplied.)

As indicated above, the AECA identifies the President as the authority to make priority decisions. One contractor wanted the priority decisions to be made at the highest possible level because he felt that officials at the service level and particularly at the arsenal level will be more reluctant to approve a sale if it establishes a contractor production line. The Military Departments are concerned that increased sales generated by the proposed legislation may adversely affect U.S. Armed Force readiness, therefore, they desire a strong say in any decision-setting priorities.

We believe that section 21(i) of the AECA provides important guidance in handling sales which may adversely affect the readiness of the U.S. Armed Forces. This section provides that

"sales of defense articles and defense services which could have significant adverse effect on the combat readiness of the Armed Forces of the United States shall be kept to an absolute minimum. The President shall transmit to the Speaker of the House of Representatives and the Committees on Armed Services and Foreign Relations of the Senate on the same day a written statement giving a complete explanation with respect to any proposal to sell, under this section, any defense articles or defense services if such sale could have a significant adverse effect on the combat readiness of the Armed Forces of the United States."

With regard to the ability to cancel a contract, section 42(e) of the AECA requires that any contract entered into under this act contain a provision stating that the contract may be cancelled in whole or in part or its execution suspended by the United States at any time under unusual or compelling circumstances required by national security. Section 42(e) also

authorizes the U.S. Government to use appropriated funds for damages and costs accruing from the cancellation or suspension of any existing procurement contract. Under the free-standing legislation cancellation clauses are not required to be inserted into each contract negotiated.

Also, the proposed legislation contains no provision offering protection to the U.S. Government should the contractor cancel the contract. If the proposed legislation were subject to applicable AECA provisions, the contractor would make advance payments to the arsenals under section 22, unless granted a Presidential exception. Also, these advanced payments could be used to cover damages caused by the contractor's cancellation.

Defense services--What do they mean?

The addition of defense services has created a mixed reaction between Government and contractor spokesmen. State, ACDA, and Defense Security Assistance Agency officials do not support providing any services other than those directly associated with the installation, testing, and certification of Government-furnished equipment. On the other hand, contractors envision an opportunity to purchase from the Government a wide range of services that will expand their ability to compete with foreign suppliers as well as with the FMS program.

The proposed legislation adopts the AECA definition of defense services (22 U.S.C. 2794(4)), which includes:

"any service, test, inspection, repair, training, publication, technical or other assistance, or defense information (as defined in section 644(e) of the Foreign Assistance Act of 1961) used for the purpose of making military sales, but does not include design and construction services under section 29 of the Act."

The drafter of H.R. 6370 believes that the U.S. Government will provide only those services required to incorporate Government-furnished equipment into an end product. According to the drafter, it was not intended that contractors should become middlemen for the purchasing country. If the services were not needed when the U.S. Government purchased the end item, then these services are not to be extended to the contractor. For example, if the U.S. Government were to provide equipment to a contractor that manufactured tanks for the U.S. Armed Forces, the equipment package would include gun tubes and mounts as well as those services required to install, test, and certify the equipment. The package would not include

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ancillary equipment such as ammunition, 1/ because ammunition would not be supplied to the prime contractor if the United States were purchasing the tank for the U.S. Armed Forces. An Office of Munitions Control official confirmed that ammunition is neither an end item nor an item incorporated into an end item.

Nevertheless, some contractors interpreted the proposed legislation as allowing them to purchase the:

- Government services needed to assemble, package, and ship ammunition and mortars to purchasing countries.
- Training to be performed domestically or overseas.
- Arsenal know-how to assist in domestic and overseas production of items now being produced in Government arsenals.
- Any other services the U.S. Government provides to friendly countries.

Various officials noted that the proposed legislation would not commit the U.S. Government to sell defense services but would only give it the right to make the sale. Therefore, the Government would continue to control the type of sales made. Nevertheless, officials of various agencies said contractors would likely pressure the Government to provide whatever services are allowed under the proposed legislation. The final interpretation of defense services may have a significant impact on the increase in volume of commercial sales resulting from the passage of this legislation.

EXPECTED VOLUME OF COMMERCIAL SALES

If the proposed legislation were enacted as an amendment to the AECA and if the type of defense services permitted were limited to installation, testing, or certification of Government-furnished equipment provided under this authority, industry and Government spokespersons foresee no dramatic increase in commercial sales due to this legislation. On the other hand, as free-standing legislation, permitting a wide range of defense services to be sold, these officials predict

1/For many types of ammunition, Government sources are the only sources able to assemble, package, and ship ammunition overseas; therefore, most ammunition is sold through FMS channels.

a rush of commercial sales activity for defense services and articles previously restricted to FMS channels. They also predict that the number of middlemen will dramatically increase.

Factors which will impede greatly increased sales activity include continued country preference to use FMS channels and the small number of end items dependent on Government-furnished equipment. If the proposed legislation incorporates the AECA provisions, the potential increase in sales will be moderated, because officials responsible for approving sales will be able to better resist contractor pressure to approve sales.

As noted, in our report of January 4, 1980 1/ countries prefer to purchase military equipment through FMS channels because (1) they pay the lowest Government price the U.S. Government can negotiate (2) they benefit from U.S. military expertise in recommending levels of support and spares, (3) they have assured rights to purchase U.S. improvements to the products, (4) inspections are made to meet U.S. standards, (5) they can buy into the U.S. logistic support system, and (6) they trust the U.S. Government. Under the proposed legislation, a commercial contractor could purchase some of these services from the U.S. Government, including certification and inspection services.

According to U.S. Government and contractor officials, the defense articles most likely to be provided to a U.S. contractor are gun mounts and tubes and canopy and seat ejection devices for jet aircraft. Officials at the Rock Island and Watervliet arsenals, producers of mounts and tubes, indicate that personnel ceilings would limit the volume of gun tubes and mounts produced by the arsenals. For these arsenals it is not a question of increased commercial sales but one of maintaining current production levels which are already heavily dependent on foreign military sales.

Navy officials indicate that, because of the potential adverse effect on U.S. readiness, there would be no sales of seat ejection devices. Moreover, the Navy believes direct sales should be discouraged because of limited shelf life; the high degree of reliability required, which is monitored constantly by in-service engineering; the need to maintain strict configuration control to insure that equipment is compatible with existing systems; and the ability to account for items sold in order to identify users if a production lot becomes defective. The Navy also believes that direct sales of training services should be discouraged, because they would disrupt the existing accounting system and place an added burden to an already meager workforce.

1/"What Would Be The Impact Of Raising Or Repealing The Commercial Arms Ceiling?" (ID-80-9).

Why commercial sales will increase

If the proposed legislation is approved as part of the AECA, commercial sales volume will probably increase somewhat because

--some countries prefer commercial channels over FMS;

--profit will motivate contractors to use the commercial channel; and

--whenever contractors' inventories build up, pressure to sell will intensify.

Industry and Government spokesmen cited as reasons why a purchaser would prefer a commercial sale (1) faster delivery, (2) new equipment, (3) flexibility to quote fixed price with penalty for late delivery, (4) avoidance of FMS administrative fee, (5) negotiated directly with manufacturer rather than through a middleman, (6) less bureaucratic red tape, and (7) support tailored to foreign countries' needs.

The new legislation is expected to enhance these advantages. For example, by ordering Government-furnished equipment in advance of a firm contract, the contractor is in a position to further expedite delivery time. Moreover, some countries, like India, for political reasons are unwilling to purchase through the FMS channel. This legislation would open sales to these countries which were lost because of the need to obtain Defense equipment through a Government agreement.

A driving force behind the proposed legislation is a projected \$1 billion sale to India. The benefiting contractor and arsenals stated that unless the contractor is able to purchase gun mounts and tubes from the U.S. arsenals, India is likely to turn to other foreign suppliers. We found that the Departments of State and Defense and ACDA generally supported this sale but India's internal politics discourages a government-to-government agreement with the United States for major weapons purchases.

The willingness of some contractors to take advantage of the proposed legislation may depend on what liability, if any, the U.S. Government will agree to assume in case of late delivery penalties resulting from Government delays in providing the equipment. (In FMS cases the Government is unwilling to assume liability for late delivery). A few contractors stated that they will not enter into sales agreements which require them to assume the risk of late deliveries of Government-furnished equipment.

Sales under free-standing
legislation

U.S. Government officials expect a larger increase of commercial sales promotion if the legislation is left free standing and defense services are not tied to end items. The decision to sell will remain with the Government, but officials fear contractor pressure to approve sales will increase. These officials feel their ability to resist this pressure is much stronger if they can point to the AECA for support.

The free-standing legislation would allow contractors to make attractive offers combining the advantages of commercial and FMS channels. A typical contractor offer may include U.S. Government certification and inspection, training by U.S. military personnel, arsenal know-how to establish an in-country production base, lower prices from eliminating U.S. administration costs and military configuration requirements, expedited delivery, ammunition and follow-on support, and any other service needed to complete the sale.

If the contractors are successful in building a large volume of back orders, contractor pressure may also develop to either lift personnel ceilings at Government arsenals or change arsenal policy to give contractors the right to produce gun tubes and mounts. Without being bridled by production constraints, the market potential is limited only by external factors, such as available financing and the ultimate demand for these weapons.

CONCLUSION

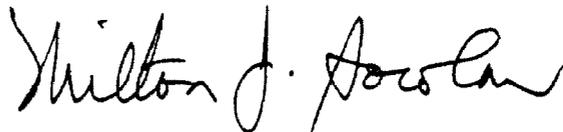
In our opinion, the protective provisions contained in the AECA should apply to contracts involving Government-furnished equipment sold to U.S. contractors for eventual export. If the proposed legislation is incorporated into the AECA, the Congress would be assured that the same reporting and implementation controls created for FMS would apply to Government sales to U.S. contractors for export. Approval of a free-standing bill related to arms exports creates a poor precedent and diminishes the effectiveness of AECA controls over military equipment sales.

For the purpose of this legislation, defense services should be restricted to installing Government-furnished equipment into contractor end items. Although there may be advantages to the U.S. Government in expanding the types of services it provides to a U.S. contractor, the agencies responsible for controlling military exports have not had an opportunity to analyze the implications of this change.

To assist you we have provided the necessary language changes to H.R. 6758 in the enclosure. These changes incorporate our suggestions concerning the intent and scope of the proposed legislation.

As arranged with your office, unless you publicly announce its contents earlier, we plan no further distribution of this letter until 5 days after its issuance to you. At that time, we will send copies to the Chairman, Senate Committee on Foreign Relations; Chairman, House Committee on Foreign Affairs; Chairmen, House and Senate Committees on Appropriations; House Committee on Government Operations, and Senate Committee on Governmental Affairs, the Director, Office of Management and Budget; the Secretaries of State and Defense; the Director of the Defense Security Assistance Agency, and the Arms Control and Disarmament Agency; and other interested parties.

Sincerely yours,

A handwritten signature in black ink, reading "Milton J. Rowland". The signature is written in a cursive style with a large initial "M".

Acting Comptroller General
of the United States

Enclosure

SUGGESTED CHANGES TO H.R. 6758

To authorize the sale of defense articles, ~~defense services, and unclassified defense service publications~~ to United States companies for incorporation into end items to be sold to friendly foreign countries.

1 Be it enacted by the Senate and House of Representatives
2 of the United States of America in Congress assembled, That
3 the Arms Export Control Act is amended by inserting after
4 chapter 2B the following new chapter: "chapter 2C--Sales to
5 United States Companies For Incorporation Into End Items"
6 "Sec. 30. General Authority." (a) subject to the conditions
7 specified in subsection (b) of this section, the ~~Secretary~~
8 ~~of Defense~~ President may, on a negotiated contract basis,
9 under cash terms (1) sell defense articles, ~~defense services,~~
10 ~~and unclassified defense service publications~~ at not less than
11 their estimated replacement cost (or actual cost in the case
12 of services), or (2) procure or manufacture and sell defense
13 articles, ~~defense services, and unclassified defense service~~
14 ~~publications~~ at not less than their contract or manufacturing
15 cost to the United States Government, to any United States
16 company for incorporation into end items (and for concurrent
17 or follow-on support) to be sold by such company on a direct
18 commercial basis to a friendly foreign country or international
19 organization pursuant to an export license or approval under
20 section 38 of this ~~the Arms Export Control~~ Act. The President
21 may also sell defense services in support of such sales of,
22 defense articles, subject to the requirements of this chapter,
23 provided, however, that such services may be performed only in

1 the United States. The amount of reimbursement received from
2 such sales shall be credited to the current applicable appro-
3 priation, fund, or account of the selling agency of the United
4 States Government.

5 (b) Defense articles and defense services, ~~and unclassified~~
6 ~~defense services publications~~ may be sold, procured and sold,
7 or manufactured and sold, pursuant to subsection (a) of this
8 section only if (1) the end item to which the articles ~~services,~~
9 ~~or publications~~ apply is to be procured for the armed forces of
10 a friendly foreign country or international organization, (2) the
11 articles, ~~services, or publications~~ would be supplied to the
12 prime contractor as government-furnished equipment or materials
13 if the end item were being procured for the use of the United
14 States Armed Forces, and (3) the articles, and services, ~~or~~
15 ~~publications~~ are available only from United States Government
16 sources or are not available to the prime contractor directly
17 from United States commercial sources at such times as may be
18 required to meet the prime contractor's delivery schedule.

19 (c) For the purpose of this section, the terms "defense
20 articles" and "defense services" mean defense articles and
21 defense services as defined in sections 47(3) and 47(4) of
22 this the Arms Export Control Act.

23 (d) Section 42(d) and 42(e) is amended by striking out
24 "and 29" wherever it appears and inserting in lieu thereof
25 "29, and 30".

26 (e) Section 21(i)(1) is amended by deleting the comma
27 following "under this section" and inserting in lieu thereof
28 "or under authority of Chapter 2B,".